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FUTURE CAPITAL HOLDINGS

INR 322

Adapting to a tough environment

ACCUMULATE

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We recently met with the management of Future Capital Holdings (FCH). The management has articulated its focus on being an efficient asset/capital allocator into businesses generating relatively higher RoEs and being an Asia-centric buy-side firm. The company aims to extract real value from alpha style investing, building a strong investment management franchise and allocating capital between retail and institutional lending, besides, enabling beta businesses as well by applying for mutual fund and portfolio management services (PMS) licenses. In this report, we discuss the management response to the following set of questions:

- ***Is there any change in approach to investment advisory in the current environment?***
- ***Is the environment posing any challenge in raising capital in PE/real estate fund?***
- ***What are the AUMs currently advised? What funds are likely to be floated in the near term?***
- ***What are the salient features and recent investments of Indospace Logistics and FVIL?***
- ***What is the change in strategy in retail financial services in the tightening monetary environment?***
- ***If cautious on retail lending, then what?***
- ***Does FCH face any human resource challenges?***
- ***What are the new businesses it is planning to look at?***

Outlook and valuations: Long term play on consumption; maintain 'ACCUMULATE'

In this non-conducive market environment, the company has deferred its plan to float another leg of real estate/PE fund by few months. Moreover, in the increasing interest rate scenario and rising concerns on retail asset quality, it is shifting its capital allocation strategy from the high yielding retail segment to the wholesale credit segment. Considering this, our revenue estimates stand revised downwards to INR 3.5 bn in FY09E from INR 3.8 bn. Consequently, we expect the company to report PAT of INR 476 mn (earlier INR 544 mn) and EPS of INR 7.5 in FY09E. We expect FY09E to be a year of investment in building franchise and scaling up of existing operations, the benefit of which will be reflected in revenues and profitability only from FY10E onwards. Our FY10 and FY11 earnings estimates remain more or less the same. Our SOTP fair value estimate stands at INR 29.1 bn or INR 460 per share and we believe that valuations will move towards our fair value estimate with better visibility on the business. We maintain our **'ACCUMULATE'** recommendation.

Financials

Year to March	FY08	FY09E	FY10E	FY11E
Net revenues (INR mn)	915	3,530	7,465	10,201
Net profit (INR mn)	(288)	476	1,840	2,336
Diluted EPS (INR)	(5.3)	7.5	29.1	36.9
EPS growth (%)		*NA*	*286.3*	*27.0*
Book value per share (INR)	109.1	116.6	145.7	176.2
Diluted P/E (x)	(60.3)	42.8	11.1	8.7
Price/BV (x)	3.0	2.8	2.2	1.8

Reuters	:	FCHL.BO
Bloomberg	:	FCHL IN

Market Data

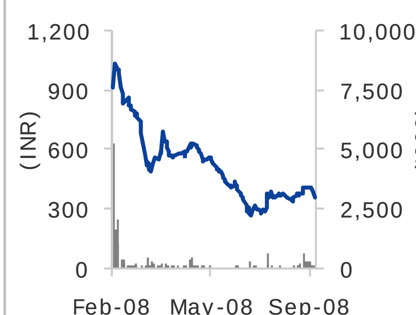
52-week range (INR)	:	1,190 / 259
Share in issue (mn)	:	63.2
M cap (INR bn/USD mn)	:	20.3 / 438.5
Avg. Daily Vol. BSE/NSE ('000)	:	211.1

Share Holding Pattern (%)

Promoters	:	75.4
MFs, FIs & Banks	:	0.6
FIIs	:	4.1
Others	:	19.9

Relative Performance (%)

	Sensex	Stock	Stock over Sensex
1 month	(8.1)	1.8	9.9
3 months	(12.1)	(14.2)	(2.0)
12 months	(12.7)	(61.4)	(48.6)



Is there any change in approach to investment advisory in the current environment?

FCH has adopted an investing style, which encompasses not taking any undue risk and seeking reasonable returns on investments. It has consciously stayed away from deploying capital from private equity/real estate funds and has invested only one-third of the ~USD 1.5 bn managed (no investments have been made from the real estate fund in the past 15 months and from the private equity fund in past six-nine months).

Is the environment posing any challenge in raising capital in PE/real estate fund?

Recently, FCH has successfully concluded the first closure of its USD 350 mn logistics fund (Indospace Logistics Partners) in this challenging environment by tapping long-term investors, namely US endowment funds and fund of funds. Undoubtedly, the environment is posing more challenges for smaller boutique fund managers, but FCH has been able to win investor interest with the following competitive advantages:

- Differentiated investing style/approach: Actively getting involved in operating and growing the companies in which they invest.
- Undertaking serious due diligence: FCH is going slow on investments; it has reviewed ~500 transactions, performed 35-40 serious due diligences, but has made only 15 investments.
- Institutionalised platform with 160 professionals and adequate infrastructure instills confidence.
- Focus on sectors not actively chased by many investors, resulting in higher risk-adjusted return.

What are the AUMs currently advised? What funds are likely to be floated in the near term?

FCH, acting as an investment advisory, currently advises on a little more than USD 1.5 bn; it recently concluded the first closure (raising USD 240 mn) of its logistics fund. It intends to expand selectively into new sectors and increase its AUM to USD 3.0-3.5 bn by FY09E and USD 5 bn by FY11E. It has built a platform (with 160 professionals) that is capable of managing higher AUMs and will maintain consistency and continuity in raising funds.

- It plans to raise another leg of private equity fund, Indivision-II, mobilising USD 650-700 mn. The first leg, Indivision-I (FDI compliant private equity fund) has made 15 investments till date, deploying 60% capital and will be substantially committed by the end of the next quarter.
- Similarly, on the real estate front, after deploying USD 160 mn (and committing USD 200 mn) in 11 retail properties and six mixed-use properties till date from Horizon-I, it plans to float Horizon–II (of USD 400 mn) early next fiscal.
- It will also launch a 'Public Market Fund' by March 2009 with a committed size of USD 400 mn, which will primarily invest in small and mid cap companies.
- The management also sounded gung-ho about Future Ventures India (FVIL), an innovative vehicle to pool permanent capital to invest in non-FDI compliant sectors. It has recently received regulatory approval for an IPO with some rider (money raised should be deployed in three years and shareholders' approval to pick up over 20% stake in any company) and is likely to tap the public market in the near term.

What are the salient features and recent investments of Indospace Logistics and FVIL?

Indospace Logistics fund will invest in setting up and leasing out 18-20 mn sq ft of industrial warehouse space (8-10 warehouses) across India in seven-eight key metros in the next two-three years. It sees the lack of a modern supply chain as a challenge for retailers, despite organised retailing growing and expanding rapidly into tier-II and tier-III cities.

FVIL is an innovative vehicle with the following features:

- Pool of permanent capital to invest in non-FDI compliant sectors.
- Seeking to create, build, acquire, invest in, and operate innovative and emerging businesses in India's rapidly growing consumption-led sectors.
- Build an entity that follows the successful business models of Berkshire Hathaway, Investor AB, and Hutchison Whampoa.

Apart from creating, building, and growing the investee company, it will also have arbitrage leverage for FII/FDI investments—FIIs will be able to hold 24% in FVIL post-listing.

FVIL has made a few investments from the USD 120 mn already floated. It recently bought 70% stake in Aadhar Retailing (a rural retail chain of Godrej Agrovert), entered into a 50:50 JV with UAE-based Axiom Telecom (one of the largest distributors/retailers of mobile phones for carrying out wholesale distribution and servicing in India), invested in women's apparel firm Biba, My Dollar Store franchisee (Sankalp Retail), SSIPL Retail, Converge M Communication, Footmarket Retail, and an Anita Dongre run entity**.**

What is the change in strategy in retail financial services in the tightening monetary environment?

In retail financing, Future Money has deliberately adopted a cautious stance in the tightening monetary conditions and has toned down growth targets to a USD 125-150 mn (INR 5-6 bn) loan book by FY09E (against USD 200-225 mn estimated previously). It has conducted due diligence on GE Money, ICICI Bank's personal loan portfolio, and has dropped its approval rate significantly to 18%.

It is also focusing on making existing Future Money outlets more profitable (than simply rolling out new outlets) and creating a product ecosystem bundling all its products and offering it to customers. Rather than targeting the loan book size in a particular period, it looks at tapping 5 mn customers (1 mn at present) and garnering profits of INR 1,000/customer by offering various financial products.

If cautious on retail lending, then what?

Within retail financial services, rather than lending it will focus more on fee-based financial product distribution—has started distributing Future Generali insurance products and has tied up with 10 mutual funds for distributing their products.

Being an allocator of capital, it will shift its focus from retail to wholesale credit business, particularly special situation-related financing, besides other innovative corporate credit, namely mezzanine financing, promoter financing, and distressed debt. In the past two months, the company has built a wholesale book of INR 3 bn and expects to end this fiscal with INR 7-8 bn. Future Capital Credit is headed by Shailesh Shirali, ex-MD-Global Structured Finance and Investments at DSP Merrill Lynch, with over 15 years of experience in the business of wholesale financing. It has also recruited senior management personnel from Barclays and Kotak.

Does FCH face any human resource challenges?

FCH has a professional and experienced management team in place, with a proven track record across various business verticals. Besides recruiting management professionals from top financial firms, it is able to retain key employees, following the transparent and open HR policies, and incentivising them well, based on their performance through bonus and ESOPs.

What are the new businesses it is planning to look at?

While the near term focus is to successfully scale up the wholesale credit business and roll out macro investment themes through FVIL; in the long term it will look at various business opportunities that align with its objective of being an efficient capital allocator and an Asia-centric buy-side firm.

Outlook and valuations: Long term play on consumption; maintain 'ACCUMULATE'

In this non-conducive market environment, the company has deferred its plan to float another leg of real estate/PE fund by few months. Moreover, in the increasing interest rate scenario and rising concerns on retail asset quality, it is shifting its capital allocation strategy from the high yielding retail segment to the wholesale credit segment. Considering this, our revenue estimates stand revised downwards to INR 3.5 bn in FY09E from INR 3.8 bn. Consequently, we expect the company to report PAT of INR 476 mn (earlier INR 544 mn) and EPS of INR 7.5 in FY09E. We expect FY09E to be a year of investment in building franchise and scaling up of existing operations, the benefit of which will be reflected in revenues and profitability only from FY10E onwards. Our FY10 and FY11 earnings estimates remain more or less the same. Our SOTP fair value estimate stands at INR 29.1 bn or INR 460 per share and we believe that valuations will move towards our fair value estimate with better visibility on the business. We maintain our **'ACCUMULATE'** recommendation.

SOTP valuations – FY10E

FY10	Method	AUMs/earnings/ book (INR mn)	Multiple (x)	Value of business (INR mn)	FCH's holding (%)	Value of FCH's interest (INR mn)	Value per share (INR)
Investment advisory	DCF	158,879	11.3	17,943	100	17,943	284
Financing business	PB	6,713	1.2	8,056	100	8,056	127
Financial product distribution	PE	147	15.0	2,206	100	2,206	35
Retail broking and wealth management	PE	34	15.0	506	50	253	4
Forex	PE	81	15.0	1,222	50	612	10
TOTAL				**29,934**		**29,071**	**460**

Source: Edelweiss research

Company description

Future Capital Holdings (FCH), incorporated in October 2005, is a fast growing non-banking financial company, offering a wide range of research, advisory services, and retail financial services. It is promoted by Pantaloon Retail (PRIL), one of the leading players in organised retail, Kishore Biyani, MD of PRIL, and Sameer Sain. Being a part of the Future Group, one of India's leading retail groups with over ten years of experience in the Indian retail sector, FCH has a deep understanding of the needs of Indian consumers. It is also supported by an experienced management team with expertise in investment banking, finance, real estate, operation, and risk management.

Investment theme

We believe that FCH offers a unique play on India's domestic consumption growth through financial services. The company is building a vertically integrated capital-cum-agency business model through its investment advisory, financing, and financial products distribution businesses. It will leverage Future Group's brand, relationships, expertise, and understanding to identify and exploit investment and financing opportunities in the consumption space.

FCH is a focused alternate investment advisor with USD 1.5 bn under advice in consumption-related sectors and plans to grow its AUM to USD 5 bn by FY11E. It has exclusive rights to offer financial products (loans, third party product distribution of insurance, credit cards, and mutual funds) at PRIL outlets. The company is also looking to venture into the wholesale financing space and offer products like mezzanine financing, promoter funding, and acquisition financing. Though most of its businesses are still at a nascent stage and execution remains the key risk, a professional and experienced management team makes us confident of the company's ability to identify and monetise emerging opportunities.

Key risks

- Currently, most of its businesses are at nascent stage; hence, timely execution remains a key risk for investors.
- Keystone is the holding company of investment managers of three offshore funds - Indivision, Horizon, and Indus Fund - currently advised by FCH through its subsidiaries. Failure in getting RBI approval for acquiring 100% stake in Keystone will lead to FCH losing its right on management and performance fees earned by the offshore investment managers.
- FCH's retail financial services operations are dependant on the group's expertise in the consumption-led sector and its distribution network. Though organised retail is currently on a high growth trajectory, there are numerous challenges, including land availability, higher rentals, improperly developed malls, underdeveloped supply chains, inadequate human resources, and protests against organised retailers that continue to stifle growth.
- Risk of fraud and higher-than-expected non-performing assets are inherent to the consumer financing business. Any deterioration in the general economic condition can increase NPAs.

Financial Statements (Consolidated)

Income statement INR (mn)

Year to March	FY07	FY08	FY09E	FY10E	FY11E
Interest income	33	401	1,770	4,224	7,457
Interest expended	25	78	568	1,628	2,970
Net interest income	8	323	1,202	2,596	4,487
Non interest income	341	585	2,319	4,864	5,712
- Financial product distribution	0	0	441	735	1,177
- Fee, PMS and forex income	0	0	233	291	360
- Investment advisory fee	341	585	1,645	3,838	4,175
Income from operations	349	908	3,521	7,460	10,199
Other income	16	8	9	5	2
Net revenues	365	915	3,530	7,465	10,201
Operating expenses	316	1,178	2,703	4,437	6,273
- Employee exp	183	559	1,241	2,108	3,108
- Depreciation /amortisation	8	35	86	124	140
- Other opex	124	584	1,376	2,205	3,025
Preprovision profit	49	(263)	827	3,028	3,928
Provisions	0	0	97	255	414
PBT	49	(263)	730	2,772	3,513
Taxes	3	20	241	915	1,159
PAT	46	(282)	489	1,857	2,354
Share of associates/minority interest	13	5	13	18	18
PAT after minority interest	34	(288)	476	1,840	2,336
Extraordinaries	0	0	0	0	0
Reported PAT	34	(288)	476	1,840	2,336
Basic number of shares (mn)	38.5	53.4	63.2	63.2	63.2
Basic EPS (INR)	0.9	(5.4)	7.5	29.1	36.9
Diluted number of shares (mn)	41.0	53.8	63.2	63.2	63.2
Diluted EPS (INR)	0.8	(5.3)	7.5	29.1	36.9

Growth metrics (%)

Year to March	FY07	FY08	FY09E	FY10E	FY11E
Net interest income		3,963	272	116	73
Net revenues growth		151	286	111	37
Opex growth		273	129	64	41
PPP growth		(637)	(415)	266	30
Provisions growth		NA	NA	162	62
PAT growth		(709)	(273)	280	27

Operating ratios (%)

Year to March	FY07	FY08	FY09E	FY10E	FY10E
Yield on assets			15.6	19.8	20.7
Yield on advances			20.1	20.6	20.3
Cost of funds			11.0	11.5	11.0
Spread			9.1	9.1	9.3
Net interest margins		7.3	10.6	12.2	12.4
Cost-income	86.6	128.7	76.6	59.4	61.5
Tax rate	5.2	(7.5)	33.0	33.0	33.0

Balance sheet **(INR mn)**

As on 31st March	FY07	FY08	FY09E	FY10E	FY11E
LIABILITIES					
Equity capital	444	632	632	632	632
Reserves & surplus	621	6,265	6,741	8,581	10,507
Net worth	1,065	6,897	7,374	9,213	11,139
Secured Loans	555	2,082	8,240	20,070	33,937
Others	18	632	632	632	632
Total liabilities	**1,637**	**9,611**	**16,246**	**29,915**	**45,708**
ASSETS					
Loans	178	2,716	13,000	28,063	45,403
Investments	535	5,020	2,500	2,000	2,000
Current Assets	187	1,772	1,502	1,950	2,428
Current liabilities	153	1,415	2,444	3,861	5,895
Net current assets	33	356	(942)	(1,911)	(3,468)
Fixed assets (net block)	883	1,519	1,688	1,763	1,773
Miscellaneous exp written off	8	0	0	0	0
Total assets	**1,637**	**9,611**	**16,246**	**29,915**	**45,708**
Loan growth		1,426.8	378.6	115.9	61.8
EA growth		972.6	79.9	93.4	56.1
Gross NPA ratio		0.4	0.7	0.9	1.1
Net NPA ratio		0.2	0.3	0.4	0.4
Provision coverage		60.0	60.0	60.0	60.0

RoE decomposition (%)

Year to March	FY07	FY08	FY09E	FY10E	FY11E
Net interest income/assets		7.3	10.6	12.2	12.4
Non interest income/assets		13.4	20.6	22.8	15.9
Net revenues/Assets		20.7	31.2	35.0	28.3
Operating expense/assets		(26.6)	(23.9)	(20.8)	(17.4)
Provisions/assets		0.0	(0.9)	(1.2)	(1.1)
Taxes/assets		(0.4)	(2.1)	(4.3)	(3.2)
Total costs/assets		(27.1)	(26.9)	(26.3)	(21.8)
ROA		(6.4)	4.3	8.7	6.5
Equity/assets		90.0	63.0	38.8	28.2
ROAE		(7.1)	6.9	22.4	23.1

Valuation metrics

Year to March	FY07	FY08E	FY09E	FY10E	FY11E
Diluted EPS (INR)	0.8	(5.3)	7.5	29.1	36.9
EPS growth (%)		*NA*	*NA*	*286.3*	*27.0*
Book value per share (INR)	24.0	109.1	116.6	145.7	176.2
Adjusted book value per share (INR)	24.0	109.0	115.6	142.8	170.6
Diluted P/E (x)	391.5	(60.3)	42.8	11.1	8.7
Price/ BV (x)	13.4	3.0	2.8	2.2	1.8
Price/ Adj. BV (x)	13.4	3.0	2.8	2.3	1.9

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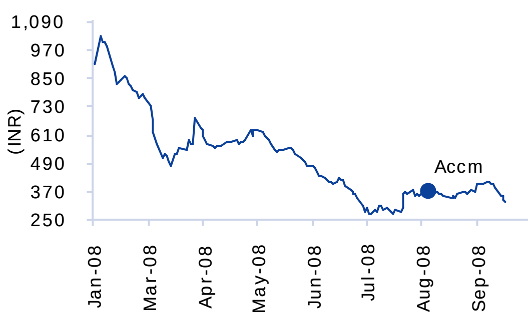
Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services:

Allahabad Bank, Axis Bank, Federal Bank, HDFC Bank, ICICI Bank, ING Vysya Bank, IOB, Karnataka Bank, Kotak Mahindra Bank, OBC, SBI, Yes Bank, IDFC, HDFC, LIC Housing Finance, PNB, Power Finance Corporation, Reliance Capital, SREI Infrastructure Finance, Shriram City Union, Syndicate Bank and Union Bank.

Future Capital Holdings



Recent Research

Date	Company	Title	Price (INR)	Recos
16-Sep-08	**ICICI Bank**	Impact of increase in global credit Spreads; *Visit Note*	628	Buy
29-Aug-08	**IDFC**	Wings clipped; *Result Update*	92	Accum.
28-Aug-08	**Banking**	Six reasons why we; Currently prefer SBI over ICICI; *Sector Update*		
26-Aug-08	**ICICI Bank**	Challenging business environment; *Visit Note*	656	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	101	58	15	7	191

* 9 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	84	71	36

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period